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Valuing Farm Corporation Stock

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VALUING FARM CORPORATION STOCK

— by Neil E. Harl*

A recent Tax Court case, *Estate of Smith v. Commissioner*,¹ has focused attention on the methodologies for valuing the stock of a minority interest in a closely-held farm corporation.² The valuation approach approved by the court produced a substantial discount from the undiscounted value of the underlying assets of \$1818 per share; the court approved a valuation of \$439 per share.³

Facts of *Smith v. Commissioner*

The estate in question was comprised of two major assets—a one-third interest in an S corporation engaged in farming operations and 12 percent of the stock in a bank.⁴ The farming operations were carried on by a farm manager and involved about 1300 acres of farmland, half of which was bottomland subject to flooding and half was forest and pasture land.⁵ The earnings for the five years before the date of death (1993) ranged from \$9243 in 1990 to a high of \$28,145 in 1992. The farm manager was paid a salary and benefits and five percent of the farm profits.

Valuation methodology approved by the court

Both the estate and the Internal Revenue Service relied heavily on expert testimony in valuing the stock. For various reasons, the Tax Court sided with the findings of the estate's expert.⁶ The estate's expert used two methods to value the stock—an asset-based approach, using price-to-asset ratios of comparable firms, and an earnings method based on the investment value of the corporation's projected stream of earnings. The court agreed that 70 percent of the weight should be placed on asset values and 30 percent on earnings.⁷

The first step was to select a group of firms comparable to the S corporation for which net asset values and market-based stock price were available. A group of publicly-traded real estate companies and real estate investment trusts were selected that were comparable to the farm corporation being valued. The amount by which the net asset values were discounted to reach market value *involved a 50 percent discount from net asset values*.

As for earnings, a five year earnings history was calculated and those earnings were discounted to present value. Starting with a riskless rate (the rate of return on long-term U.S. government bonds), that rate was adjusted upward for risk *with a discount rate of 26 percent used to determine the present value of the stock*.⁸

Finally, a discount of 35 percent for non-marketability and minority interest was applied.⁹

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The result was valuation of the minority interest of the S corporation stock at \$439 per share, down from an undiscounted value of \$1818.¹⁰

Precedential value of the decision

Will *Estate of Smith*¹¹ become a dominant precedent in valuing farm corporation stock? Certainly the decision breaks new ground in two areas—(1) the 26 percent discount rate for valuing the earnings stream and (2) the 50 percent discount from asset value to determine fair market value of the stock. The 35 percent discount for minority interest and non-marketability is not pathbreaking. A number of courts have approved comparable or even greater discounts¹² including some Circuit Courts of Appeal.¹³

But a 50 percent discount from asset values to stock values and a 26 percent discount rate in valuing the earnings stream in addition to the discount for non-marketability set *Smith v. Comm'r*¹⁴ apart from most other decisions.

Impact on planning

Valuing stock for federal estate tax (or even federal gift tax) purposes is only one of the reasons why stock is valued. A major reason is that stock may be sold to younger family members, stock may be used to pay part of the compensation for younger employees and stock value may be an important element in dispositive plans routing stock to on-farm heirs and other assets to off-farm heirs. In all of these situations, tax considerations may lurk in the background but a major consideration is fairness within the family.

An obvious question—is the *Smith v. Comm'r*¹⁵ methodology likely to be viewed as equitable as between or among the heirs? And if that methodology is not employed, and other valuation approaches are used to value stock during life, will that influence the Internal Revenue Service—and the courts—as values are placed on the stock at death? Certainly, if *Smith v. Comm'r*¹⁶ is upheld on appeal, and if the principal concern is valuation for death tax purposes, the prudent planning approach would seem to be to avoid valuation methodologies that could be interpreted as placing a higher value on the stock at death. On the other hand, if frequent transfers of stock during life are contemplated, and considerations of fairness loom large, those factors should be weighed against a highly discounted value at death.

Another issue—is *Smith v. Comm'r*¹⁷ applicable to other forms of organization? Certainly the element of control may

be a greater factor with corporations than with other organizational alternatives and the income tax consequences of liquidations may be more severe with corporations (particularly C corporations) than for organizational options based upon partnership tax treatment. However, the decision should carry some weight with valuation of the so-called pass-through entities based upon partnership tax status.

FOOTNOTES

- ¹ T.C. Memo. 1999-368.
- ² See generally 8 Harl, *Agricultural Law* § 58.05[2][c] (1999); Harl, *Agricultural Law Manual* § 7.02[5][d] (1999).
- ³ Estate of Smith v. Comm'r, T.C. Memo. 1999-368.
- ⁴ *Id.*
- ⁵ *Id.*
- ⁶ *Id.*
- ⁷ *Id.*
- ⁸ *Id.*
- ⁹ *Id.*
- ¹⁰ *Id.*
- ¹¹ T.C. Memo. 1999-368.
- ¹² See, e.g., Furman v. Comm'r, T.C. Memo. 1998-365 (40 percent combined discount for minority interest and non-marketability and 10 percent to reflect fact majority owner was key person in management); Estate of Brookshire v. Comm'r, T.C. Memo. 1998-365 (40 percent discount allowed for stock in family-held grocery chain); Dockery v. Comm'r, T.C. Memo. 1998-114 (40 percent discount for minority interest and lack of marketability).
- ¹³ Estate of Berg v. Comm'r, T.C. Memo. 1991-279, *aff'd on these issues*, 976 F.2d 1163 (8th Cir. 1992) (estate entitled to 20 percent minority discount and 10 percent for lack of marketability for 26.9 percent ownership in closely-held real estate holding company); Estate of Ford v. Comm'r, T.C. Memo. 1993-580, *aff'd*, 53 F.3d 924 (8th Cir. 1995) (20 percent discount for minority interest and 10 percent for non-marketability; net asset value methodology used). Compare Mandelbaum v. Comm'r, T.C. Memo. 1995-255, *aff'd*, 91 F.3d 124 (3d Cir. 1996) (30 percent discount (for federal gift tax purposes) allowed for non-marketability).
- ¹⁴ T.C. Memo. 1999-368.
- ¹⁵ T.C. Memo. 1999-368.
- ¹⁶ *Id.*
- ¹⁷ *Id.*

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

COLOR OF TITLE. The plaintiffs sought to quiet title to 1.2 acres of pasture land which lay on the plaintiff's side of a creek which ran between the parties' properties. The plaintiff

claimed title under a deed which generally described the disputed land. The defendant claimed that the deed was insufficient color of title to the property because the deed did not contain a precise legal description of the disputed land. The plaintiff presented a surveyor as an expert witness who testified that the description was adequate to determine the boundaries of the land described in the deed. The court held that this evidence was sufficient to provide the plaintiff with